BEFORE THE

Federal Communications Commission

WASHINGTON, D.C.

In re Applications of U S WEST, INC., Transferor, and QWEST COMMUNICATIONS INTERNATIONAL, INC., Transferee for Consent to Transfer Control	)	CC Docket No. 99-272

PETITION TO DENY
OF MCLEODUSA TELECOMMUNICATIONS SERVICES, INC.

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McLeodUSA Telecommunications Services, Inc., and its other competitive local exchange carrier ("CLEC") affiliates[1] (collectively "McLeodUSA"), by its attorneys, hereby petitions the Commission to deny the above-captioned application of U S WEST, Inc. ("U S WEST") and Qwest Communications International, Inc. ("Qwest" and collectively the "Applicants").[2] The Applicants have failed to demonstrate that the proposed

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1 These affiliates are Ovation Communications of Minnesota d/b/a McLeodUSA, Ovation Communications of Illinois d/b/a McLeodUSA Telecommunications, McLeodUSA Communications of Wisconsin, Inc., BRE Communications LLC d/b/a McLeodUSA, and Dakota Telecom, Inc.

2 Merger of U S WEST, Inc. and Qwest Communications International, Inc. Application for Transfer of Control (Aug. 19, 1999) ("Application"). The Application was placed on Public Notice on September 1, 1999, Public Notice DA 99-1775.

transaction would promote competition and otherwise serve the public interest; indeed, the Application provides so little information that it is facially insufficient to meet the required burden of proof and is therefore not grantable. However, what is known about the proposed transaction indicates that, absent the imposition of conditions as discussed below, the Commission should find that the merger is contrary to the public interest.

I. INTRODUCTION AND SUMMARY.

McLeodUSA is a CLEC offering integrated telecommunications services, including local, long distance, high speed digital access and data services, to both business and residential customers throughout the Rocky Mountain and the Midwest regions. Currently, McLeodUSA offers service (using a combination of resale, unbundled network elements, and its own facilities built to end-users) in seven of the states in U S WEST's 14 state region, and plans to enter the remaining seven states in that region in the near future. As a CLEC relying on both resale of LEC facilities and UNEs, McLeodUSA is dependent on U S WEST for essential inputs, and is in the position of being both a customer and a business competitor of U S WEST. As an ILEC, U S WEST has the incentive to deny, delay, and degrade services provided to McLeodUSA and similarly situated wholesale customers/local telephony competitors, and has in fact acted upon those incentives to the detriment of local competition. Indeed, U S WEST's service quality for both wholesale and retail customers has been seriously deficient for quite some time. The rationale underlying the proposed merger strongly indicates that U S WEST's service quality will continue to worsen, perhaps at an accelerating rate.

Pursuant to the Communications Act of 1934, as amended (the "Act"), the Commission must be persuaded that a proposed merger is in the public interest, convenience and necessity.[3] Further, it is incumbent upon the parties filing an application to bear the burden of proceeding and the burden of proof as to whether the merger is in the public interest.[4] The Application does not come close to meeting the burden of proof established by Congress and the Commission.

Instead of attempting to meet the required burden of proof, the parties merely offer unsubstantiated assertions that the proposed transaction presents neither Section 271 issues nor adverse competitive effects. Indeed, as shown herein, far from establishing that the proposed transaction is in the public interest, the Application as filed raises more questions than it answers. For example:

- Notwithstanding Qwest's claims to be in the process of exiting the CLEC business, Qwest's in-region CLEC assets and activities would provide the combined entity with an even greater ability and incentive to act anticompetitively than U S WEST currently possesses today.

- Qwest has openly stated its plans to divert as much of the revenue earned by the U S WEST assets as possible to fund Qwest's entry into the high-margin broadband business around the world. The almost certain result

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3 See 47 U.S.C. §§ 214(a), 310(d).

4 See id.

will be even further neglect of basic local services provided to retail and wholesale customers in the U S WEST region.

- The Applicants have failed to describe how they will ensure Section 271 compliance with regard to several of the services covered in the Application, and have failed even to mention how they will achieve compliance with regard to the provision of dark fiber, an important Qwest interLATA service. Indeed, in a letter to a McLeodUSA affiliate, a Qwest senior attorney characterizes certain Section 271 compliance assurances made in the Application as "false representations."[5]

The Application is fraught with ambiguities and omissions. Far from meeting Applicants' statutory burden of proof, the Application is so devoid of details as to render it ungrantable in its present form.

II. THE APPLICATION IS FACIALLY INADEQUATE TO MEET THE STATUTORY BURDEN OF PROOF FOR APPROVAL OF THE TRANSFER OF FCC AUTHORIZATIONS.

Under the Act, the proponents of a transfer of control application before the Commission bear the burden of proceeding and the burden of proof as to whether grant of the Application would serve the public interest, convenience, and necessity.[6] Indeed, the Commission "must be persuaded that the transaction is in the public interest, convenience and necessity" before a merger can be approved.[7] The public interest standard is a

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5 Letter of Sept. 6, 1999, to Scott F. Cate, President, Access Long Distance, from Stuart L. Crenshaw, Senior Attorney, Qwest ("Crenshaw Letter"). See Section III.B herein for a further discussion of this correspondence.

6 See 47 U.S.C. §§ 214(a), 310(d).

7 In re Applications of NYNEX Corporation, Transferor and Bell Atlantic Corporation, Transferee, Memorandum Opinion and

flexible standard encompassing the "broad aims of the Communications Act,"[8] and the Commission has held that "in order to find that a merger is in the public interest, we must . . . be convinced that it will enhance competition."[9] The Commission has determined that, if an applicant cannot carry the burden of establishing that any harms to competition are outweighed by public interest benefits, its application must be denied.[10]

In Bell Atlantic/NYNEX the Commission specified the analysis that must be undertaken by proponents of a merger such as that presented here:

> With respect to mergers that may present horizontal market power concerns, we begin by defining the relevant markets, both in terms of the relevant products and geographic scope. Once we have defined the relevant markets, we identify the market participants, especially the most significant market participants. Next, we evaluate the effects of the merger on competition in the relevant market, such as whether the merger is likely to result in either

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Order, 12 FCC Rcd. 19985, 19987 (1997) ("Bell Atlantic/NYNEX Order").

[8] Id., citing Western Union Division, Commercial Telegrapher's Union, A.F. of L v. U.S., 87 F. Supp. 324, 332 (D.D.C. 1949), aff'd, 338 U.S. 864 (1949). See FCC v. RCA Communications, Inc., 346 U.S. 86, 93-95 (1953); Washington Utilities and Transportation Comm'n. v. FCC, 513 F.2d 1142, 1147 (9th Cir. 1976).

[9] Id. at 19987.

[10] See id. Pursuant to Section 309 of the Act, the Commission may not act upon an application unless it determines "that there are no substantial and material questions of fact." If such questions are raised, the Application must be designated for hearing. As shown herein, there exist many substantial and material questions of fact that arise as a result of the proposed merger that have not been adequately addressed by the Applicants. If, after a hearing to address these issues, the Commission determines that the Applicants have not met the required burden of proof, the Application must be denied.

> unilateral or coordinated effects that enhance or maintain the market power of the merging parties. In addition, we also consider the effect of the merger on the Commission's ability to constrain market power as competition develops . . . We also consider whether the proposed transaction will result in merger specific efficiencies . . . we would also examine whether the proposed merger has vertical effects that enhance market power.[11]

The Application falls woefully short of meeting the required burden of proof. Indeed, the Applicants have made only a cursory effort to satisfy this burden by submitting an application premised on bald assertions and devoid of analysis. The Applicants ignore the competitive harms that will be caused by the merger, asserting that the merger presents neither Section 271 issues nor adverse competitive impacts. Both of these claims are wrong, and are, categorically, insufficient to demonstrate that the proposed merger will enhance competition and otherwise serve the public interest under the standard set forth in Bell Atlantic/NYNEX. Under that standard and for the reasons set forth below, the Commission must find that the Application and the underlying merger presents issues that raise substantial and material questions of fact. Accordingly, the Application should be designated for hearing as facially insufficient to meet the required burden of proof.

First, the Applicants have not demonstrated that the proposed merger will enhance competition; indeed, the Application fails to demonstrate that the merger will not cause adverse

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11 Bell Atlantic/NYNEX Order at 20008 (citations omitted).

competitive impacts in U S WEST's 14 state region. Most importantly, the Applicants do not provide information at any level of detail regarding Qwest's or its affiliates' CLEC activities within U S WEST's region. Rather, the Applicants merely state that Qwest "for some time has been in the process of exiting this line of business."[12] For example, the Application does not even mention Advanced Radio Telecom, Inc. ("ART"), an entity holding CLEC certification in several states in U S WEST's region, in which Qwest holds a 19 percent interest.[13] Qwest and ART have an operating agreement whereby Qwest will be the exclusive provider of ART's backbone services, and ART will provide wireless fiber to Qwest.[14] If the proposed merger is approved, the parent entity will have interests in both the ILEC and a CLEC.[15] This would give the merged entity the ability to benefit Qwest by delaying, denying or degrading access provided to non-affiliated CLECs, thereby placing competitors such as McLeodUSA at a competitive disadvantage to the merged entity. As described herein, there are other CLECs operating in U S WEST's region in which Qwest owns an interest. Because the Applicants have not provided the Commission with sufficient information to

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12 Application at 13.

13 See Qwest Press Release, "Qwest Communications Expands High-Speed Network into 19 Local Markets," February 24, 1999, <www.qwest.com/press/story.asp>.

14 See id.

15 Given the lack of detail provided in the Application, there may be other issues that would have an adverse competitive impact in the market unbeknownst to the Commission or McLeodUSA.

enable the Commission to determine whether the merger will produce adverse competitive impacts, the Application must be denied or designated for hearing.

Second, the Applicants have inadequately addressed issues related to Section 271 of the Act, stating only that Qwest will discontinue or reconfigure services to ensure compliance with Section 271.[16] As the Commission is well aware, the market-opening provisions of Section 271 comprise one of the cornerstones of the Telecommunications Act of 1996. In order to determine whether the merger is in the public interest, the Commission must be presented with information and facts proving that the proposed merger will not undermine these important goals. The Applicants have simply failed to adequately plead this issue, much less carry their burden of proof. For example, the Applicants have not provided information regarding Qwest's in-region facilities, such as whether the Applicants will continue to hold the facilities or whether such facilities will be sold to an independent third party. If Qwest were to continue to hold its in-region facilities and continue its provision of dark fiber in-region, the proposed merger raises substantial questions regarding compliance with Section 271, and provides the merged entity with a means to circumvent the requirements of Section 271 altogether.[17] Because the Applicants have not

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[16] See Application at 14.

[17] This is just one possible issue regarding Section 271 compliance. Because the Applicants have filed very little information, there may be other factors unbeknownst to the

provided information necessary for the Commission to assess whether the proposed merger is consistent with Section 271, the Application should be designated for hearing and subsequently denied.

Finally, the Applicants merely make vague statements that the merger will have the substantial public interest benefits of offering advanced services, increasing competition, and providing more incentives to satisfy Section 271.[18] As the Commission held in Bell Atlantic/NYNEX, "applicants cannot carry their burden if their efficiency claims are vague or speculative . . . [or] cannot be verified by reasonable means."[19] As shown herein, the Applicants' claims that the merger does not produce anticompetitive effects and provides incentives to satisfy Section 271 are wrong, and the Applicants' claim that the merger will increase competition in out-of-region markets is entirely unsupported. Because the Applicants have failed to meet their required burden of proof, the Application must be designated for hearing and subsequently denied.[20]

Commission or McLeodUSA that would also suggest that the merger would raise additional Section 271 concerns.

18 See Application at 14-18.

19 Bell Atlantic/NYNEX Order at 20064.

20 Should the Applicants submit material to supplement the Application at a later date, the Commission should process any such submission as a major amendment under Section 309(b) and (c) of the Communications Act, which require that such amendments be placed on Public Notice and 30 days provided for the submission of petitions to deny. This will allow McLeodUSA and other potentially interested parties to participate formally in this

III. SUBSTANTIAL AND MATERIAL QUESTIONS ARE PRESENTED BY THE PROPOSED MERGER AND LEFT UNRESOLVED BY THE APPLICATION

A. Contrary To Assertions By The Applicants, The Proposed Merger Will Harm The Development Of Competitive Local Telephone Service In U S WEST's Region.

The Applicants urge upon the Commission that "no one could rationally argue that the combined company would have less incentive to facilitate local competition than U S WEST does today."[21] Presumably the Applicant's confidence in this regard flows from the superficial and conclusory nature of the Application; without question, McLeodUSA's and the Commission's ability to test this assertion is substantially impaired by the dearth of information supplied in the Application. In any event, this facile claim obscures and overlooks three critical facts relating to the proposed merger. First, as a large ILEC, U S WEST presently has substantial incentive and ability to deny, delay, and degrade the ability of CLECs to provide a competitive local telephone service in U S WEST's region -- and, as documented below, U S WEST has indulged this incentive by paying almost no attention to the service quality it offers to wholesale customers/competitors such as McLeodUSA.

Second, and contrary to the unsupported assertion of the Applicants, because Qwest has both CLEC activities and assets in U S WEST's 14 state region, the merged entity will have a greater incentive and ability to deny, delay, and degrade service to non-

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proceeding once the relevant issues have been adequately identified by the Applicants.

21 Application at 18.

affiliated CLECs. Third, and perhaps most importantly, it appears that the primary effect of the proposed merger will be the diversion of U S WEST revenues away from ensuring service quality to both retail and wholesale customers in order to fund Qwest's advanced service ambitions outside of U S WEST's region. This will virtually ensure that the services made available to competitive entrants like McLeodUSA will be further degraded from their already sorrowful state.

The Applicants completely ignore these issues and make no effort to demonstrate that allowing the merged entity to provide both ILEC and CLEC services in the same area will not harm competition. Instead, the Application states simply that Qwest "has been in the process of exiting this business line."[22] In these circumstances, this facile statement simply cannot carry the Applicants' burden of demonstrating that grant of the Application will serve the public interest, and the Application should be denied.

1. U S WEST Has Strong Incentives And A Demonstrated Ability To Deny, Delay, And Degrade Competitive Local Telephone Offerings.

U S WEST's present incentive and ability to deny, delay, and degrade services to competitors are palpable and have impeded CLECs such as McLeodUSA in their efforts to provide a competitive local telephone service. For example, local competitors attempting to enter the U S WEST service area must purchase

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22 Id. at 13. Note that this statement does not commit Qwest to actually exit the CLEC business in U S WEST's region.

essential inputs from U S WEST. Even where it constructs its own network, McLeodUSA must still purchase many inputs, such as interconnection and unbundled elements, from U S WEST. At every step in the entry process, therefore, McLeodUSA has no choice but to remain the customer of the incumbent monopolist.

But unlike other kinds of customers, McLeodUSA is U S WEST's competitor. As both the supplier of essential inputs of production and a competitor, U S WEST has the incentive to withhold inputs or to provide them to McLeodUSA on discriminatory terms and conditions. Most obviously, U S WEST can withhold inputs entirely (for example by making services central to McLeodUSA's business plan unavailable for resale), and has actually prevented McLeodUSA from entering a market at all by doing exactly that.[23]

Even where U S WEST cannot completely evade its legal obligation to provide wholesale services, it has the incentive to raise its rivals' costs by creating a "price squeeze."[24] It can

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[23] Moreover, AT&T has filed complaints in five states alleging that U S WEST continually fails to meet its obligations regarding access service, and often refuses to provision certain services at all. See, e.g., AT&T Communications of the Mountain States, Inc., Complainant, v. U S WEST Communications, Inc., Respondent, Complaint and Request for Expedited Treatment, filed August 18, 1999 with the Colorado Public Utilities Commission.

[24] See T.G. Krattenmaker and S.C. Salop, Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price, 96 Yale L.J. 209 (1986); P.L. Jaskow, Mixing Regulatory and Antitrust Policies in the Electric Power Industry: The Price Squeeze and Retail Market Competition, in Antitrust and Regulation: Essays in Memory of John J. McGowan 173-239 (F.M. Fisher ed., 1985); S.C. Salop and D.T. Scheffman, Raising Rivals' Costs, 73 Am. Econ. Rev. Papers & Proc. 267 (1983).

do so by convincing regulators to allow it to set the price for the inputs above U S WEST's costs of providing them to itself. U S WEST can then lower its retail prices to reflect its unfair cost advantage, thus forcing McLeodUSA to match the U S WEST price reduction and reduce profit margins (likely discouraging further entry) or to maintain retail prices at existing levels and accept a loss in market share.

U S WEST can also achieve the same harmful result through more subtle means. For example, it can delay delivery of inputs, withhold dissemination of information regarding changes in network inputs, and generally provide services to McLeodUSA that are inferior to those U S WEST provides to itself. If McLeodUSA receives lower quality service from U S WEST but must incur the same cost for the service as U S WEST, U S WEST again gains an unfair price advantage.

Raising rivals' costs is an inexpensive means of disciplining existing entrants and discouraging further entry. Furthermore, because of the vast size of its service areas, the "returns" on a U S WEST investment in raising its rivals' costs are greater than is the case for a smaller incumbent LEC. That is, a reputation as an unfair competitor, one that will fiercely oppose any competitive entry, benefits U S WEST for long periods of time in all of the other geographic areas within its region by deterring or limiting entry in those other areas.[25] Because it

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25 See J.A. Ordover and G. Saloner, "Predation, Monopolization, and Antitrust" in Handbook of Industrial

is so difficult for regulators to prevent discriminatory pricing and the degradation of service, the risk of regulatory detection and penalties is also small.

U S WEST has acted on its incentives in both subtle and blatant ways to increase the cost and degrade the quality of the wholesale services it is required to provide to CLECs. No local competitor is more familiar with this problem than McLeodUSA. For example, U S WEST:

- Attempted to withdraw Centrex, the vehicle upon which McLeodUSA depends for market entry, just prior to the signing of the 1996 Act in its entire 14 state region, and was successful in delaying entry in Colorado, North Dakota, South Dakota, and Minnesota. Entry was prevented entirely in Nebraska, Idaho, and Montana;

- Attempted to impose a so-called Interconnection Cost Adjustment Mechanism charge, designed to recover from CLECs the cost U S WEST incurred in upgrading facilities and processes to accommodate interconnection with competitors, throughout its entire 14 state region;

- Failed to provide station message detail recording service, which tracks interexchange messages carried over McLeodUSA's resold lines, thus preventing McLeodUSA from providing its customers with accurate long distance call detail and preventing McLeodUSA from billing customers for significant amounts for long distance service;

- Attempted to eliminate the "Assumed 9" function in Iowa and Minnesota on resold Centrex lines, thus forcing McLeodUSA customers to dial "9" before making any call;

- Restricted, for no technical reason, the number of service conversions U S WEST would process for McLeodUSA to one service conversion per hour, per central office;

- Failed to implement adequate order entry processes and systems, and refused McLeodUSA's offer to pay for or design an improved order entry process throughout the region;

Organization, Vol I, 550-556 (R. Schmalensee and R.D. Willig, eds., 1989).

- Chronically failed to process resale orders accurately throughout the region;

- Refused to include correct information for McLeodUSA resale customers in the U S WEST LIDB database, thus causing degradation in such services as Caller ID in at least one state;

- Imposed the requirement, for no technical reason, that a separate Centrex system (or "common block") must be established for each Centrex customer, even though U S WEST imposes no such restriction on its own Centrex customers;

- Failed to meet the industry standard of a five day interval for processing resale orders in roughly 90 percent of order requests regionwide;

- Imposed unreasonably high recurring and nonrecurring charges for directory listings;

- Refused to allow McLeodUSA customers to switch from standard service to Centrex service on nondiscriminatory terms, in some cases imposing a separate charge on McLeodUSA customers that wanted to keep their telephone numbers, without subjecting its own customers to such charges; and.

- Refused to provide voice messaging service, even at retail, for McLeodUSA to provide to its own customers.

2. The Addition Of In-region CLEC Assets To U S WEST's ILEC Operations Does Increase U S WEST's Harmful Incentives And Ability.

There is every reason to believe that the proposed merger will increase U S WEST's incentive and ability to engage in the kinds of actions described above. Indeed, by virtue of the proposed merger, Qwest will gain control over U S WEST's ILEC business, while Qwest and/or certain of its affiliated interests continue to provide CLEC service throughout the U S WEST region. By combining an ILEC with an in-region CLEC, the merged entity will have a greater incentive and ability to hinder competition in U S WEST's 14 state region.

Although the Application states that Qwest is in the process of exiting the CLEC business, publicly available information suggests that Qwest's in-region CLEC swansong has yet to come. As recently as February 1999, Qwest issued a press release detailing its expanded end-to-end connectivity for local service to large businesses in metropolitan markets, including Seattle, Washington.[26] Qwest and/or its wholly-owned subsidiaries LCI, Qwest Corporation, Phoenix and USLD are certified to provide competitive local exchange service in 12 of U S WEST's 14 states.[27] There has been no indication in these states that any of these entities has moved to cancel such authority. In addition, Qwest holds a 19 percent equity interest in ART,[28] which is certified as a CLEC in all of the states in U S WEST's territory except South Dakota and Wyoming. ART is currently providing service in Arizona, Oregon, and Washington.

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26 See Qwest Press Release, "Qwest Communications Expands High-Speed Network into 19 Local Markets," February, 24, 1999, <www.qwest.com/press/story.asp>.

27 These entities are not certified to provide service in Arizona or New Mexico.

28 See Qwest Press Release, "Qwest Communications and Investor Group Commit $251 Million to Advanced Radio Telecom to Expand its High-speed Local Wireless Network," June 1, 1999, <www.qwest.com/press/story.asp>.

Moreover, Qwest has also invested in Covad Communications, a packet-based CLEC.[29] Covad has received local exchange service certification in Utah and has an application to provide local exchange service pending in Washington. Qwest has entered into a contract with Advanced TelCom Group ("ATG"), a facilities-based CLEC, to provide it with wholesale communications services.[30] ATG has been investing resources in Oregon telecommunications infrastructure to "compete directly with U S WEST."[31]

The existence of both an ILEC and one or more CLECs wholly-owned by Qwest post merger increases the merged entity's incentive to deny, delay, and degrade service to competitors because such actions will benefit not only the ILEC, but also the commonly-owned in-region CLEC services. The extent of the increase in incentives will, of course, depend upon the extent to which CLEC activities are important to Qwest on either a strategic or revenue basis -- this the Commission cannot determine absent much more detailed information from Qwest. However, the merger gives the merged entity not only an increased

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29 See Qwest Press Release, "Qwest Communications Invests in Covad Communications and Announces Strategic Deal for Digital Subscriber Lines," January 19, 1999 <www.qwest.com/press/story.asp>.

30 See Qwest Press Release, "Qwest Awarded $63 Million Agreement from Advanced TelCom Group," April 26, 1999, <www.qwest.com/press/story.asp>.

31 See ATG Press Release, "New Phone Company to Compete With U S WEST", June 23, 1999, <www.atgi.net/pubs/springfield.html>, visited September 13, 1999.

incentive to engage in anticompetitive behavior, but also the increased ability to do so.[32]

For example, the ILEC (U S WEST) would be able to use the CLEC (Qwest and its affiliates) to attempt to avoid the ILEC's obligations under Section 251(c)(4) of the Act to offer for resale, at wholesale rates, any services the ILEC offers at retail. Because the CLEC would not be subject to such obligations, the ILEC could transfer service packages and promotions to the CLEC without subjecting the corporate entity to resale obligations. Thus, the ILEC could protect its local exchange customer base from resale competition because the CLEC affiliate servicing the end users would have no statutory duty to offer its services for resale at the wholesale discount. Competitors would be precluded from purchasing at wholesale the service packages and promotions the combined entity chooses to offer through the CLEC but not the ILEC.

Of course, the FCC, local regulators, and customers in the U S WEST region have seen all of this before. The problems posed by the Qwest deal are highly reminiscent of U S WEST's attempts in the 1980s to segregate its directory publishing businesses from its local exchange businesses. In a series of transactions in 1984, Mountain Bell, U S WEST's operating affiliate in seven

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[32] The Commission has a pending docket before it to determine the appropriate legal and regulatory status of ILEC affiliates providing local exchange service in the ILEC's service area. See, Commission Seeks Comment of Petition Regarding Regulatory Treatment of Affiliates of ILECs, CC Docket No. 98-39, DA 98-627 (rel. April 1, 1998).

of its states, transferred the assets of its directory publishing subsidiary to the U S WEST parent company. Regulatory commissions in several states quickly realized that the transfer would result in the diversion of revenue (more than $40 million) received from Mountain Bell's highly profitable Yellow Pages directories out of the LEC's rate base. The Arizona, Wyoming and Colorado commissions rightly sought to unwind the transfer. While Arizona (via a settlement agreement)[33] and Colorado (through an order prohibiting the transfer)[34] were ultimately successful and Wyoming was not (its order prohibiting the transfer was overturned on appeal on jurisdictional grounds),[35] the lesson is clear.

In addition, the combined entity will have the ability to divert favored, high-volume customers to the affiliated CLEC, which can become the provider of new, innovative local services, while the ILEC's traditional local services are degraded and serve only residential users and other CLECs. Here, the combined entity will be able to divert its resources to the CLEC and allow

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33 See M. Ahern "Consumers To Save $43M As ACC, Mountain Bell Settle," The Business Journal Phoenix & The Valley of the Sun, Sec. 1, p. 3 (June 13, 1988) (describing settlement as allowing transfer but treating the directory publishing revenue as still part of the rate base).

34 See Mountain States Tel. And Tel. Co. v. Public. Util. Comm'n of Colorado, 763 P.2d 1020 (Colo. 1988) (upholding Colorado PUC order requiring Mountain Bell to unwind the transfer to the extent necessary to resume directory publishing in Colorado).

35 See Mountain States Tel. And Tel. Co. v. Public. Serv. Comm'n of Wyo., 745 P.2d 563 (Wyo. 1987).

the ILEC network to become increasingly outdated while developing a state-of-the-art network for the CLEC, thus degrading the service available to unaffiliated CLECs.

Similarly, the ILEC can discriminate in favor of its affiliated CLEC. The combined company would have the ability to allow the ILEC to provide overpriced UNEs, while the CLEC affiliate selectively provides retail services using those UNEs that do not reflect the full costs charged by the ILEC. The affiliated CLEC would have a substantial advantage over unaffiliated new entrants, such as McLeodUSA.

This concern is far from speculative. AT&T has recently filed complaints in five of U S WEST's states alleging that U S WEST unreasonably discriminates against competitors in favor of its affiliated entities. Specifically, AT&T alleges that it has asked U S WEST to provide information regarding facilities that are at or near capacity, as well as those central offices where U S WEST has elected to make significant expansion.[36] AT&T alleges that U S WEST provides this information to its affiliates while denying the information to AT&T, thereby discriminating against unaffiliated CLECs.

Finally, the proposed merger will enable U S WEST (the ILEC) to undercompete against Qwest (the CLEC). For example, in

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[36] See, e.g., Complaint of AT&T Communications of the Midwest, Inc. Against U S WEST Communications, Inc. Regarding Access Service, Complaint and Request for Expedited Proceeding Under §§ 237.61 and 237.462, filed August 18, 1999 with the Minnesota Public Utilities Commission.

contracts to secure new customers, if Qwest and U S WEST are the primary rivals, the Applicants would not be inclined to compete as hard as they would if the entities were not under common control. Regardless of which entity actually captured the customer, Qwest, as the ultimate parent of both the CLEC and ILEC, would benefit.

3. The Rationale Underlying The Proposed Merger Virtually Assures That CLECs In U S WEST's Region Will Have Their Services Degraded As Revenues That Could Be Used To Improve Service Quality Are Diverted To Other Out-Of-Region Purposes.

Year after year, U S WEST is cited for its inability to keep up with telecommunications retail industry norms for trouble reports, held orders, and consumer complaints. No U S WEST customer would be surprised to learn that, in a recent customer surveys conducted by the Yankee Group, U S WEST finished last for overall customer satisfaction among the BOCs.[37] Regulators have worked hard to address the problem: Since 1996, regulatory commissions in Arizona, Colorado, Idaho, Montana and Minnesota have together imposed more than $12 million in service-related fines on U S WEST while other commissions have imposed millions of dollars in rate cuts as penalties for poor service.[38]

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[37] See T. Klass, "U S WEST Service Criticized In Consumer Study," AP (Dec. 18, 1998).

[38] See Letter from Morton Bahr, President, Communications Workers of America to Governors in the U S WEST region at 2 (June 21, 1999). See also, In re U S WEST Communications, Inc., Order Setting Penalty Amount and Initiating Procedure to Determine Use of Penalty Funds, Docket No. P-421/CI-95-648, 1999 WL 713652 (Minn.P.U.C.)(an investigation found U S WEST's service quality to be "seriously deficient" in responding to requests for new service); In re U S WEST Communications, Inc., Order to Show

Unfortunately, these penalties have not caused U S WEST to improve its service.

The fact that these service quality problems exist is not surprising, given that U S WEST is subject to some form of price cap or "incentive" regulation in nine of the 14 states in its region for at least some of its services. As the Commission has recognized, price cap regulation can "adversely affect service quality or technology innovation."[39] The Department of Justice similarly has acknowledged that "the LECs [] may reduce investment, reduce or discontinue maintenance, lay off personnel, and, ultimately, allow deterioration of physical plant in order to reduce costs and increase profits."[40]

While service quality problems on the retail side are extremely serious, the problem is even worse for the customers of U S WEST's wholesale CLEC services. As with retail service, U S WEST simply has not allocated adequate resources to ensure that its wholesale customers receive good service. But the problem

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Cause, TC97-192, 1998 WL 417390 (S.D.P.U.C.)(noting U S WEST's "history of laxity in providing service to South Dakota customers and those seeking to become its South Dakota customers"); Washington Utilities and Transportation Commission, Complainant, v. U S WEST Communications, Inc., Respondent, Decision and Order Rejecting Tariff Revisions, Docket No. UT-970766, 1998 Wash. UTC LEXIS 42 (noting that U S WEST needed to improve its service quality "to achieve true and long-lasting resolution of the Company's unacceptable, less-than-adequate performance.").

[39] Policy and Rules Concerning Rates for Dominant Carriers, CC Dkt. No. 87-313, Further Notice of Proposed Rulemaking, at ¶ 83 (rel. May 23, 1988).

[40] See id. at ¶ 90 (characterizing commenters' concerns) (citations omitted).

with wholesale service quality is even more pervasive because, as demonstrated above, U S WEST has a powerful incentive to refuse to meet its obligations to its wholesale CLEC customers.[41]

There can be little doubt that both retail and wholesale service provided by U S WEST will only get worse if the Qwest-U S WEST merger is approved in its current form. Qwest's plan is simply to divert U S WEST's revenues and resources away from local telephone services to fund Qwest's global high speed data strategy. Under the plan, retail and wholesale customers in the U S WEST region can only lose.

In order to deliver fast growth, Qwest is aggressively building capital-intensive digital networks around the world. Qwest plans to complete construction of its 20,500 mile fiber optic network in North America this year and has formed a partnership with KPN, a Dutch telecommunications company, to build and operate a 2,100-mile fiber optic network in Europe.[42] In addition, Qwest has invested in undersea cables linking North America with Europe and with Asia.[43] The company also plans to build expensive metropolitan area networks in 25 markets as part

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41 This discussion focuses on wholesale services U S WEST provides to its competitors in the local market. The discussion does not address other wholesale services U S WEST provides, such as access services it provides to long distance carriers.

42 See Qwest Communications International Inc. Form 10K For Fiscal Year Ending Dec. 31, 1998, at 4.

43 See id.

of its national CLEC strategy.[44] After agreeing with US WEST on the terms of the proposed merger, Qwest's CEO Joseph Nacchio promptly announced that the buying/construction spree is far from over. For example, Mr. Nacchio stated that the merged company will "need a data wireless play nationally."[45] Given that the combined company would own only a few wireless licenses covering a limited geographic area, establishing a national wireless network would require more massive capital expenditures. In sum, as Mr. Nacchio stated, "[w]e don't define our territory as 14 states. We think of it as the world."[46]

Qwest has financed its world-wide business primarily by selling debt and equity rather than through operating revenues. For example, in 1998, Qwest's operating revenues were $45 million, but it raised $1.477 billion through various financings.[47] The company had more than $1.4 billion in capital expenditures in 1998.[48] In the first six months of 1999, Qwest's net earnings reached only $23 million,[49] a tiny amount given the firm's massive capital investment needs.

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44 See "Qwest Focuses On National CLEC, Wireless Strategy With U S WEST," Communications Daily (July 20, 1999).

45 See id.

46 E. Russo, "Stock Swoon Tarnishes Qwest Bid," Omaha World-Herald, Bus. p.16 (June 15, 1999).

47 See Qwest Communications International Inc. Form S-4 at 73, filed with the Securities and Exchange Commission on August 12, 1999 ("Qwest S-4").

48 See id.

49 See id.

In contrast to Qwest, U S WEST is a "slower-growth enterprise[]."[50] But U S WEST has what Qwest needs: "cash and customers."[51] For example, U S WEST had net revenues in 1998 of approximately $1.5 billion.[52] U S WEST's net revenues for the first six months of 1999 were $818 million, more than <u>35 times</u> Qwest's net revenues for the same period.[53] Moreover, U S WEST can be acquired inexpensively because, as Merrill Lynch analysts observed not long before the companies negotiated the pending agreement, "RBOCs and incumbent local phone companies have significantly undervalued stocks."[54]

Industry analysts have been quick to grasp the logic behind Qwest's bid for U S WEST. While Qwest and Global Crossing were competing to acquire U S WEST, one industry analyst was described as concluding that "both want to bolster their fledgling businesses with real assets while they still have a relatively overvalued currency."[55] As the analyst put it, "[t]hese deals don't feel strategic;" instead "[t]hey feel like they are just

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[50] L.M. Holson, Market Place "The battle for U S WEST and Frontier shows how difficult the sector has become to analyze," N.Y. Times (June 21, 1999).

[51] <u>Id</u>.

[52] <u>See</u> U S WEST, Inc. Form 10K/A For Fiscal Year Ending Dec. 31, 1998 at F-1.

[53] <u>See</u> Qwest S-4 at 75.

[54] Merrill Lynch Telecom Services Comment (June 15, 1999).

[55] L.M. Holson, Market Place "The battle for U S WEST and Frontier shows how difficult the sector has become to analyze," N.Y. Times (June 21, 1999).

trying to lock in the value of their high-priced stock by merging with another company."[56] As another analyst described the situation, Qwest (and Global Crossing) "have been under lots of pressure to use their frothy market valuations to acquire some real operations, revenues and a sustainable customer base."[57] Those real operations, revenues and captured customer base are seen as cheap sources of capital for Qwest's global strategy.

It seems clear that Qwest is primarily motivated by the desire to trade in its highly valued stock for a U S WEST business whose revenues can finance Qwest's ambitious business plans outside the region. In fact, the companies have already announced that the they will slash the annual dividend on U S WEST's stock from more than two dollars per share to a nickel per share after the merger closes.[58] The companies estimate that this reduction in the dividend, along with certain "capital expenditure synergies," will free up $7.5 billion for future investment. Qwest explained the theory of the deal as follows:

> We believe we will be able to redeploy our capital in the years 2000 through 2005 in the aggregate amount of approximately $7.5 billion toward new investment in Internet applications and hosting, out-of-region facilities based competitive local exchange service, out-of-region broadband access and Internet services, wireless expansion and video entertainment. We believe we can fund this redeployment of capital with

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56 Id.

57 See "Qwest vs. Global Crossing: How Their Merger War Will End," Business Week Online (July 16, 1999).

58 Compare Qwest S-4 at 75 (listing historic dividends paid on U S WEST shares) with id. at 72 (stating that the quarterly dividend on the stock after the merger will be $0.0125, or five cents per year).

> approximately $5.3 billion of savings from the reduction in the dividends currently paid by U S WEST and $2.2 billion of savings from capital expenditure synergies[59]

This proposed "redeployment" of U S WEST revenues from shareholder dividends to investments in Internet-related services, out-of-region entry, wireless expansion and video raises serious concerns as to whether the proposed merger will promote the public interest. The companies propose to gamble U S WEST's return on investment -- earned on the back of still captive ratepayers -- on risky ventures that have nothing to do with plain old local telephone service. Whether or not that gamble pays off, U S WEST's monopoly customer base is likely to end up paying the price in the form of even more degraded service quality or higher prices.

Finally, there can be no question that Mssrs. Nacchio and Anschutz will have enough power in the new company to execute their plan. Mr. Nacchio will be CEO of the new Qwest.[60] The Merger Agreement provides that an "Office of the Chairman" will be established, consisting of Mr. Nacchio, Philip F. Anschutz, the largest shareholder of Qwest, and Solomon Trujillo, the current Chairman and CEO of U S WEST.[61] Since the Office of the Chairman takes action by majority vote, the Qwest team seems

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59 See id. at 28.

60 See Merger Agreement at § 6.12.

61 See id. § 2.07(ii).

likely to have their way.[62] Indeed, a telling symbol of the transformation is that the surviving company will be called Qwest Communications International, Inc.[63]

In sum, the proposed "merger" will almost certainly result in the diversion of resources away from the provision of local telephone retail and wholesale service by U S WEST, further degrading the quality of both. While customers in other parts of the United States and the world might benefit from the combined company's investment in broadband networks funded by U S WEST ratepayers, wholesale customers -- like McLeodUSA -- in the 14 state U S WEST region will receive even more shoddy service.

4. Contrary To Assertions By The Applicants, Section 271 Cannot Be Relied Upon To Ensure That U S WEST Will Open Its Local Telephone Service Areas To Competition.

The Applicants argue that the merger "creates strong new incentives. . . for a post merger Qwest to meet the Section 271 criteria as soon as possible."[64] Indeed, the Applicants go so far as to claim that "[t]he entire rationale of this transaction depends upon interLATA relief,"[65] and that Qwest will have "very strong incentives to reenter the in-region market quickly, driven

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62 See id. at § 2.07(iv).

63 See id. at § 2.08(i).

64 Application at 17.

65 Id.

by the combined company's continuing out-of-region interLATA business and its national network."[66]

These arguments are unavailing for essentially two reasons. First, while it is true that Congress attempted to blunt the ILECs' harmful incentives by making compliance with the market-opening provisions of the Section 271 competitive checklist a precondition of BOC interLATA entry,[67] it is also true that Section 271 has not provided U S WEST with any noticeable incentive to meet its statutory obligations to its local competitors.

U S WEST has apparently determined that the benefits it could gain from carrying interLATA traffic originating within its region are less substantial than the cost it would incur from losing local market share if its local market were fully open to competition. Such a response by U S WEST is entirely consistent with the number of interLATA minutes of use that originate in U S WEST's region as compared to other RBOCs. According to a report prepared by the Industry Analysis Division of the Common Carrier Bureau of the FCC, three billion fewer minutes originate in U S WEST's region on an annual basis than any other RBOC (counting SBC, Ameritech, Bell Atlantic and GTE as separate entities, i.e. pre-merger).[68] The difference between U S WEST and Bell Atlantic

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[66] Id.

[67] See 47 U.S.C. § 271.

[68] See Preliminary Statistics of Communications Common Carriers for 1998, 1998 LEXIS 2632, Table 2.10 (rel. June 1, 1999).